Credit to the Private Sector: The 'Unsung and Forgotten Hero' in the Banking Crisis

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This spotlight is written in memory of Dr Samih Antoine Azar, who passed away a year ago.

Trillion LBP	CPS	PC	PI	GDP	ΔCPS	ΔPC	ΔPI	ΔGDP	g
2004	30.598	35.299	6.601	39.165					
2005	28.019	34.166	6.761	40.217	-2.579	-1.133	0.160	1.052	2.686%
2006	29.328	35.260	6.762	40.840	1.309	1.093	0.001	0.623	1.550%
2007	33.083	37.826	8.387	44.643	3.755	2.567	1.625	3.802	9.311%
2008	37.139	41.422	10.470	48.691	4.056	3.596	2.083	4.049	9.069%
2009	38.669	46.822	13.694	53.674	1.530	5.400	3.224	4.982	10.232%
2010	47.829	50.938	13.567	57.954	9.160	4.116	-0.127	4.281	7.975%
2011	52.604	49.394	13.590	58.457	4.775	-1.544	0.023	0.503	0.867%
2012	53.935	54.166	13.997	59.956	1.330	4.772	0.408	1.499	2.565%
2013	58.091	55.832	15.502	62.251	4.157	1.665	1.505	2.295	3.828%
2014	62.665	58.271	14.997	63.798	4.574	2.439	-0.505	1.546	2.484%
2015	64.456	59.678	14.240	64.092	1.790	1.407	-0.757	0.295	0.462%
2016	67.692	59.711	15.476	65.089	3.236	0.033	1.235	0.996	1.555%
2017	69.990	59.836	15.640	65.677	2.298	0.125	0.164	0.588	0.903%
2018	64.700	58.289	16.173	64.439	-5.290	-1.548	0.532	-1.238	-1.885%
Average	**49.253**	**49.127**	**12.391**	**55.263**	**2.436**	**1.642**	**0.684**	**1.805**	**3.700%**

Source: CAS, BDL; figures are in constant 2010 prices

In the debate that is currently raging in Lebanon about the viability of the banking system and whether it will ever regain the public' s confidence, there is one essential ingredient that is missing: bank credit to the private sector. And it has been missing or forgotten because it is the one thing that banks have stopped doing completely since October 2019, for understandable reasons as no sound bank would want to lend in such an ultra-risky environment[1]. The point, however, is that banks' *raison d'être* is financial intermediation, or to intermediate between savers and investors, or more generally between the providers of funds and the users of funds, and that means primarily the extension of credit to the private sector. And the fact that this essential function has been absent for the past four and a half years has proved disastrous to the economy, let alone banks, as this short spotlight will amply show.

The Central Administration of Statistics (CAS) has generated National Accounts data for Lebanon starting in 2004 and it expresses them both in nominal terms and in real terms or in constant 2010 prices (the latter discounts the effect of inflation on the nominal values); and the data for credit to the private sector is generated, of course, by BDL. The table above uses these two sources to present data for credit to the private sector (CPS), private consumption (PC), private investment (PI), GDP, and the changes to these variables (Δ), in addition to GDP growth (g). The table, actually, speaks for itself, and runs from 2004 to 2018, the last year before the onset of the crisis. We can derive from it the following important observations:

1) CPS witnessed its largest *increases* between 2007 and 2011, from 33.1 trillion LBP to 52.6 trillion LBP. This coincided with the largest *increases* in GDP growth that averaged 9% during the period.

2) As important, CPS *fell* by 5.3 trillion LBP in 2018, and not surprisingly GDP growth fell to a *negative* 1.9% -- the first time negative growth was recorded during the period. Moreover, CPS fell also in 2005 – the year of Prime Minister Hariri's assassination – by 2.6 trillion LBP but this didn't coincide with a negative growth in GDP, as net exports compensated in growth terms to the fall in CPS, something that didn't happen in 2018 because imports remained fairly strong (most likely because of the Syria channel)[2].

3) Changes in CPS seem to affect private consumption more than private investment. In the two instances where changes in CPS were negative – 2005 and 2018 – PC fell by 1.1 trillion LBP and 1.5 trillion LBP respectively.

4) Moreover, during the entire period, changes in CPS averaged 2.4 trillion; this was divided into an average change in PC at 1.6 trillion LBP and an average change in PI at 0.7 trillion LBP. As such, changes in CPS tend to affect *twice* the changes in PC than in PI.

5) What it is the exact effect of changes in CPS on changes in GDP? To answer this question, we need to resort to the concept of the *Elasticity of GDP with respect to CPS (E), which is measured as the % change in GDP divided by the % change in CPS, or more formally (in terms of averages)*:

[1] In fact, loans paybacks have been on a sliding roller coaster since October 2019, falling from around 56 billion USD to about 7 billion USD now, and causing in the process a shrinkage in banks' assets base and the real money supply

2 In 2005, net exports contributed 4.7% to GDP growth, whereas in 2018 they contributed -1.6%; see CAS, Lebanese National Accounts, 2020.

E = (ΔGDP/ΔCPS).(CPS/GDP)
= (1.805/2.436).(55.263/49.253) = (0.741).(1.122) = 0.83

An elasticity of 0.83 means that a 1% increase in CPS will produce a 0.83% increase in GDP or, roughly, a 1 dollar increase in CPS will produce an 88 cents increase in GDP. This is a fairly significant relationship.

It is generally believed, and rightly so, that a banking system is indispensable to the economy as it facilitates payments, transfers, savings… etc, but mostly because it facilitates financial intermediation. In this respect, it is not just the dearth of FX and the deterioration in exchange rates and what have you, that are proving to be so hard on the economy, but perhaps more importantly it is the halt to private credit extension as well[3]. And this is because, as the ‘unsung and forgotten hero’, CPS is a prime factor in raising GDP and living standards, especially in a country like Lebanon where capital markets are rudimentary and private equity markets hardly exist. As such, it is truly an ‘economic and financial crime’ that CPS has been reduced to its shadow for four years running, without any action whatsoever to restructure and reform the banking sector so as to kick-start CPS again! That is why such an action is badly needed now and, as importantly, why confidence in banks will be ultimately restored as it is only banks that can play a decisive role in lifting growth and development in Lebanon.

[3] It is useful to comment that private credit extension and financial intermediation in general started witnessing a decline in 2015 onwards as more of banks’ deposits were increasingly being transferred – mostly involuntarily – to BDL so as to shore up its FX reserves.

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